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No. 79-858

In the Supreme Court of the United States

OCTOBER TERM, 1979

JOAN E. KIRKPATRICK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinion of the district court (Pet. App. A-1 to A-7) is reported at 449 F. Supp. 186. The opinion of the court of appeals (Pet. App. A-8 to A-14) is reported at 605 F. 2d 1160.

JURISDICTION

The judgment of the court of appeals was entered on September 10, 1979. The petition for a writ of certiorari was filed on December 4, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the interest paid on bonds issued by a state authority was taxable income to the bondholders under Section 103(b) of the Internal Revenue Code of 1954 because the proceeds of the bond issue were used to

construct an office building in which substantially all the space was ultimately leased to non-exempt persons for use in their trades or business.

STATEMENT

This is a suit for refund of federal income taxes paid by petitioner on interest income which she received during 1973 and 1974 on $175,000 in principal amount of Mercy Hospital Building Series First Mortgage Gross Revenue Bonds issued by the Oklahoma Industries Authority (Pet. App. A-8 to A-9). The Authority, an agency of the State of Oklahoma, issued these bonds for the purpose of financing the construction of a medical office building, the Mercy Doctors Tower, which was built adjacent to Mercy Hospital in Oklahoma City (Pet. App. A-1, A-9). At or about the time that the bonds were issued, the Authority and Mercy Hospital, a tax-exempt charitable hospital, entered into a lease under which the Authority agreed to issue the bonds and build the Tower, and the Hospital agreed to lease the Tower from the Authority (Pet. App. A-9). The Hospital then subleased space in the Tower to a variety of tenants, including physicians, a medical laboratory, a sandwich shop, a pharmacy, an optician, and a dress shop (*ibid.*). None of these subtenants was a tax-exempt organization (*ibid.*).

On audit, the Commissioner of Internal Revenue determined that the interest petitioner received on the Mercy Hospital Building Series bonds was taxable. In this refund suit brought by petitioner in the United States District Court for the Western District of Oklahoma, the district court upheld the Commissioner's position (Pet. App. A-1 to A-7). The court of appeals affirmed. It ruled that the Mercy Hospital Building Series bonds were industrial development bonds within

the meaning of Section 103(b) of the Code so that the interest paid on the bonds was not exempt from federal income tax under Section 103(a)(1) (Pet. Ap. A-8 to A-12),

ARGUMENT

The decision below correctly held that the interest paid on the Mercy Hospital Building Series bonds was not exempt from federal income tax because those bonds were industrial development bonds under Section 103(b).

Petitioner argues (Pet. 9-11) that the court of appeals misconstrued Section 103(b) of the Code when it held that the use of the Tower by its non-exempt subtenants in their trades or businesses was sufficient to classify the bonds in question as industrial development bonds. However, Section 103(b)(2)(A) provides that an industrial development bond is any obligation "the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person." The terms of the statute—which employs the broad phrase "directly or indirectly"—require that the proceeds of a tax-exempt bond issue cannot be used in any manner for a commercial project such as the Mercy Doctors' Tower.

The essence of the Mercy Doctors' Tower project was that the Oklahoma Industries Authority undertook to build a medical office building in order to lease it to an exempt hospital which, in turn, intended to sublease all the space in the building to various non-exempt persons for use in their trades or businesses. Thus, the ultimate use of the proceeds of this bond issue was to provide office facilities for the non-exempt persons who would eventually lease space in the Doctors' Tower, and the master lease to Mercy Hospital served merely to achieve that result. As a result, the proceeds of the bond issue

were "indirectly" used in the trades or businesses of non-exempt persons. Therefore, the interest in question cannot enjoy exemption. Indeed, the legislative history of this provision confirms that Congress intended to prohibit the use of just the kind of master lease and sublease arrangement involved here as a device for conferring tax-exempt status on an issue which would otherwise be a non-exempt industrial development bond. See H.R. Conf. Rep. No. 1533, 90th Cong., 2d Sess. 34 (1968).

Petitioner argues (Pet. 9-11) that the legislative history of Section 103 shows that Congress intended to sanction the use of the proceeds of a tax-exempt bond issue for the construction of facilities to be leased to non-exempt persons for use in their trades or businesses, as long as those facilities are used for purposes which do not constitute an unrelated trade or business with respect to the exempt lessor. But the legislative history upon which petitioner relies does not support her contention. Petitioner quotes (Pet. 9-10) a passage from the legislative history with certain omissions which completely change the meaning of the quoted passage. The second full sentence in the quotation appearing on page 10 of the petition is followed in the original by a sentence (omitted in the petition) which shows that Congress intended to prohibit, rather than to permit, the use of the proceeds of a tax-exempt bond issue in the type of project involved in this case. The passage appears in the legislative history of the Revenue and Expenditure Control Act of 1968, in a document entitled Explanation of the Bill H.R. 15414 as Agreed to in Conference

(Conference Committee Print), 90th Cong., 2d Sess. 15 (1968).[1] The entire passage reads as follows:

> The result of these exemptions for governmental units and certain exempt organizations is to exempt bond issues such as those issued by a State or local governmental unit to finance dormitory facilities for tax-exempt educational institutions, or to finance hospital facilities for tax-exempt hospitals (charitable), since bond issues for the use of specified types of exempt organizations are not included in the first element of the definition of industrial development bonds. *This results because no other person is directly or indirectly using the dormitory or hospital facilities in a trade or business.* [Sentence omitted by the petitioner included and emphasized.]

It is therefore clear that the legislative history is fully in accord with the decision below with respect to whether the proceeds of a bond issue are used *directly or indirectly* in any trade or business carried on by a non-exempt person. Bonds issued to construct a college dormitory and a hospital building qualify for exemption; a commercial facility such as the Mercy Doctors' Tower does not.

Similarly, petitioner quotes the third sentence from the Explanation of the Bill out of context (see Pet. 10). In the original of the Conference Committee Print, *supra*, the sentence upon which petitioner relies appears after the discussion of both elements of the test for an

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[1]Petitioner cited this passage as part of H.R. Conf. Rep. No. 1533, 90th Cong., 2d Sess. (1968). However, it does not appear in that conference report, but rather in a separate unnumbered document which was issued as a Conference Committee Print, as cited in the text.

industrial development bond which is now contained in Section 103(b)(2) of the Internal Revenue Code. See Conference Committee Print, *supra*, at 16. The "exempt activities" referred to in the sentence are not any exempt activities of the tax-exempt lessor of the facility, but rather the special "exempt activities" referred to in Section 103(b)(4) of the Code, which may be financed with the proceeds of a tax-exempt bond issue even if such proceeds are used in the trade or business of a non-exempt person.[2] Petitioner has never claimed, and cannot claim, that the construction of a medical office building adjacent to a tax-exempt hospital is an "exempt activity" within the meaning of Section 103(b)(4).

[2]An example of such an "exempt activity" is the construction of air or water pollution control facilities, which is made exempt by Section 103(b)(4)(F) of the Code. This exemption is frequently relied upon by states and local governments to encourage industries in their communities to reduce air and water pollution. In a typical transaction, the governmental unit finances the construction of the necessary facility at a reduced interest cost with the proceeds of an issue of tax-exempt "pollution control bonds" and then leases the facility to its prospective industrial user, passing on the cost savings in the form of lower rentals. Although Congress provided an exemption for this and certain other types of transactions which it believed to be in the public interest, no general exemption was provided for an activity merely because it was related to the exempt activities of the tax-exempt lessor.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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